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IN THE

Supreme Court of the United States

October Term, 1954

In the Matter
of the
ONONDAGA LITHOLITE COMPANY,
Bankrupt.
No. 27,773
In Bankruptcy

First Trust & Deposit Company,
Respondent,

Receiver of Salt Springs National Bank, Joseph T. Connolly; Anna C. Doyle, Howard T. Yates, George C. Zett, and George A. Langan, as Trustee of Bankrupt's Estate,
Petitioners.

Docket
No. 722

BRIEF FOR RESPONDENT OPPOSING PETITION FOR WRIT OF CERTIORARI.

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BRIEF FOR RESPONDENT OPPOSING PETITION FOR WRIT OF CERTIORARI.

Respondent's appendix filed with Second Circuit will be frequently referred to in this brief. So, for brevity, when

used herein the letters "Apx." mean such appendix, and "F" refers to a folio or folios thereof.

Questions presented determinable only from circumstances of this case.

Thus, a sentence of the Second Circuit's decision reads:

> "We hold that the Bankruptcy Court was without power *in the circumstances of this case*, to order the subordination of the appellant's claim." (emphasis supplied) See appendix attached to petition, p. 33.

Also on page 36 of same appendix:

> "The case would be different if the trustee in the state-court action had not fully recovered the assets or the value thereof from the transferee-creditor. This is not such a case."

Furthermore, the Circuit Court did and could review only the question of whether, *under the circumstances of this case*, the Bankruptcy Court erred in barring respondent's claims from sharing in any of bankrupt's assets except $309. This is because no one appealed from the Bankruptcy Court's adjudication that respondent's claims "in the face amount of $616,233.23 are valid claims against this bankrupt estate". (Apx. p. 19, F. 57).

The only appeal was by respondent from the part of the order of the Bankruptcy Court subordinating its claims. (Apx. p. 4, F. 10-11).

All proof in Bankruptcy Court was documentary except unquestioned testimony of petitioner's attorney. (Apx. 67, F. 199-203).

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THE CIRCUMSTANCES

After 1913, bankrupt's only product was artificial building stone, with its Syracuse plant and equipment being designed and adaptable chiefly for such purpose. (Apx. pp. 37-38, F. 111-113).

In 1923, "to raise money for the purpose of discharging and paying certain debts * * *, and to borrow money for the transaction of its business * * *", (Apx. p. 59, F. 175) bankrupt issued and sold $200,000 of its ten-year 7% serial bonds, secured by a first mortgage, dated July 1, 1923, on substantially all its physical assets. A Utica bank was trustee of such mortgage. (Apx. p. 39, F. 116-117).

By 1928, the proceeds of such bonds had been spent and bankrupt lacked funds for continuance of its operations. It "sustained losses in all of its fiscal years after its fiscal year ending January 31, 1927", except for a profit of $7,328 in its fiscal year of January 31, 1931 to January 31, 1932. (Apx. pp. 38-39, F. 114-116).

Consequently, to keep going, in 1928 bankrupt borrowed $75,000 from respondent and a like amount from Salt Springs National Bank of which petitioner Joseph T. Connolly is the present receiver. But such borrowings were soon lost. (Apx. pp. 39-40, F. 117).

In 1929, bankrupt's president and principal stockholder "became inactive because of illness" and voting control of bankrupt's stock was assigned to three individuals, namely, bankrupt's new president, a vice-president of Salt Springs National Bank and a vice-president of respondent. Any two of such voting trustees had "voting

control" of bankrupt's stock for five years or until earlier payment of the bank borrowings. (Apx. pp. 43, 60-61, F. 128-129, 178-182).

By 1932, the bank loans had increased to $105,000 from each bank with the total of losses in the previous four years being $226,859. Also bankrupt's mortgage-debt was coming due on July 1, 1933. (Apx. pp. 39-40, F. 117-118).

Obviously, this meant bankrupt would soon lose all its properties, through foreclosure of its mortgage and judgments on its bank debts, unless its debts were effectively postponed with opportunity afforded, through new working capital, for continuance of its operations in trying to make them profitable.

Accordingly, bankrupt evolved and tried to consummate a plan for conversion of its bank loans into three-year 6% unsecured debentures, and its mortgage debt into ten-year 7% unsecured debentures, with the excess of the latter also being sold, if possible, on a public offering to produce new working capital. (Apx. pp. 50-56).

The plan succeeded to this extent only. The two banks converted their loans of $105,000 each into said 6% debentures and holders of all the $183,100 of mortgage bonds, except for $18,900 thereof, exchanged same for the 7% debentures. (Apx. p. 40).

So, bankrupt was still without working capital or other funds and foreclosure of its mortgage was about to occur at the instance of holders of the unexchanged mortgage bonds. Also, the Salt Springs Bank had been permanently closed, which necessarily left this respondent as the only source of further borrowing by bankrupt. (Apx. pp. 40-41, F. 120-121).

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As it turned out, unfortunately for respondent it then believed "there was a fair chance" for bankrupt "to operate profitably" with further "working capital loans". (Apx. p. 40). So, respondent was persuaded to continue such loans, which also necessitated its acquisition of the outstanding $18,960 of mortgage bonds, except for a $100 bond with an unknown owner, to prevent a then imminent foreclosure of the mortgage. (Apx. p. 41, F. 121-122).

Respondent's purchase of such defaulted bonds, of course, put it in a position to cause an immediate foreclosure which it did not do. Instead, it merely held the bonds and continued the further working capital loans until they totaled nearly a half million dollars and, as the state court found, until there was reasonable cause for beliefs that bankrupt's "operations could not be made profitable" and all persons familiar with its affairs so believed. (Apx. pp. 43, 45-46). In each of the five years from 1933, bankrupt "sustained a cash loss" with its losses in those years totaling about $524,000. (Apx. p. 39).

Early in 1938, respondent's officers and executive committee decided "to make no further loans to" bankrupt, "except for the purpose of completing work already started under contracts then outstanding." (Apx. p. 42). This necessarily resulted in bankrupt's operations tapering to the closing point in July 1938. (Apx. p. 44).

Shortly thereafter respondent, as owner of bankrupt's outstanding mortgage bonds, took the required steps for a foreclosure by the mortgage trustee, a Utica bank. (Apx. p. 44).

By the time of the foreclosure sale, November 8, 1938, the liens against the mortgaged properties totaled $38,944,

consisting of $27,315.75 for unpaid principal and interest on the mortgage bonds, $8,599.70 of unpaid real estate taxes and $2,578.55 of foreclosure expenses. (Apx. p. 70).

While bankrupt's plant was still operating with the borrowed funds, unsuccessful efforts were made to obtain a purchaser for its business and properties, and during the foreclosure "there were many closed factory plants for sale in the Syracuse area" and "quantities of machinery, equipment and tools". (Apx. pp. 41, 48).

In advance of the foreclosure sale, respondent determined not to bid thereat more than $27,000, which was the limit of the authority of its representative at the sale. His first bid of $25,000 was accepted because of no other bid. (Apx. pp. 46-47).

Only $6850 realized by respondent from properties purchased at foreclosure-sale.

Shortly after receipt of the foreclosure deed, respondent started selling the machinery, equipment and tools covered thereby. Such sales produced a gross of $6,850, which the final decision and judgment in the state court action determined to be the full market value of the mortgaged personalty. (Apx. pp. 29, 48).

Respondent never realized anything from the real estate covered by the foreclosure deed, which it never sold and against which taxes accumulated until it was taken by the City of Syracuse in a defaulted tax proceeding. (Apx. pp. 62-63).

This bankruptcy proceeding was instituted on June 30, 1939 by the receiver of Salt Springs Bank and petitioner

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Howard T. Yates and George C. Zett, and the state court action was commenced in January 1941. (Apx. p. 41).

Nature and origin of the claims filed and allowed in the bankruptcy.

Petitioner Connolly's $142,012 claim is based on the 6% debentures taken, as detailed above, in 1932 by Salt Springs Bank under bankrupt's recapitalization plan, which contemplated further working capital borrowings in affording bankrupt a chance to try to make its operations profitable.

Claims totaling $56,437, held by petitioners Anna C. Doyle, Howard T. Yates, George C. Zett and 28 others, are based on the aforesaid 7% debentures they took in 1932 in exchange for mortgage bonds under said recapitalization plan.

The 7% debentures were convertible into bankrupt's Class A non-voting stock entitled to yearly dividends at the rate of $7.00 per share before any dividends on its other stock, plus an amount equal to the excess above $7.00 per share paid in any year on the other stock. So the claims thereon partly involve interests equivalent to those of stockholders. (Apx. p. 55).

No payments of either principal or interest were ever made on any of the 6% or 7% debentures and no one ever attempted to collect anything thereon, except by filing claims in this bankruptcy. No such claims were filed on $118,700 of the 7% debentures. (Apx. pp. 50, 64).

The 19 miscellaneous claims totaling $2,760 are based on unpaid franchise taxes, freight bills, contributions, rents, etc. (Apx. p. 64).

One of respondent's two claims is exactly like petitioner Connolly's said claim since it is based on the 6% debentures, taken in 1932 by respondent as related above.

Respondent's other claim represents bankrupt's above described further borrowings from respondent in trying to make bankrupt's operations profitable.

All of bankrupt's debts, represented by each of respondent's claims, were incurred before and entirely independent of the foreclosure-transfer.

As to unlawful "going concern" recovery sought in trustee's state court action.

Throughout such action, and as determined therein by the appellate courts, petitioners endeavored to obtain an unlawful recovery on the theory that bankrupt's properties had a *going concern* value at the foreclosure time, in spite of its above noted financial history. This attempt was continued into the Court of Appeals by the plaintiff-trustee's immediate appeal from the Appellate Division's disapproval of such theory. (Apx. pp. 27-28; 302 N. Y. 932).

Additionally, it should be noted that petitioners, in the state court action, asked for recovery only of the damages sustained by claimholders other than respondent, namely, the proportion of the fictitious going concern value which the amount of such other claims, $201,210, bore to all the allowed claims, $817,443. (Apx. pp. 6-7, F. 18).

Thus, the plaintiff-trustee's pleadings in the action asked for recovery of the full amount of such other claims on the basis of allegations therein that the value of the preferentially transferred assets was $797,731 or sub-

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stantially four times the amount of the other claims. (Apx. p. 37). As computed, the proportion of the amount of the other claims to the amount of all claims is 24.6%.

In the state court action, the Appellate Division reversed the Trial Court's determinations that the foreclosure-transfer violated New York statutes and reversed and disapproved the Trial Court's findings as to the value of the transferred assets. (Apx. pp. 29, 31, F. 85, 91-92).

In its new findings, the Appellate Division fixed the market value of the transferred assets at $35,000 for the Syracuse real estate, $6,850 for the Syracuse equipment and tools and $13,000 for the Gouverneur quarry. (Apx. pp. 37-39).

Final decision in state court action (277 App. Div. 1090, affd. 302 N. Y. 932).

The Appellate Division's majority decision reads as follows

> "We feel the court erred in placing a value on the assets of Onondaga Litholite Company as a going concern at a time when concededly the company was insolvent. Under such circumstances, market value, we believe, is the correct standard to be applied in determining the value of said assets and in arriving at *plaintiff's loss*. We find the market value of said assets to be $54,850 against which should be credited the sum of $25,000 paid upon the foreclosure sale. The difference of $29,850, with interest thereon ascertainable by computation from August 1, 1938, represents the *damage suffered by plaintiff*. In the absence of other evidence, we have accepted as market value the book value of the Gouverneur quarry. Having

adopted market value as the standard for determining damages, we find no error in the court's exclusion of evidence as to subsequent sales of the real property." (Apx. pp. 27-28; 277 App. Div. 1090, 1091; emphasis supplied).

Mathematical determinations and results of final decision and judgment in state court action.

1.	Market value of transferred assets:		
	Syracuse real estate	$35,000	
	Tools and equipment	6,850	
	Gouverneur property	13,000	
			$54,850.00
2.	Price respondent paid at foreclosure sale on Nov. 8, 1938		$25,000.00
3.	Excess of market value over price trustee's damage		$29,850.00
4.	Interest on 6% on such excess included in final judgment of Dec. 12, 1950—trustee's damage		$21,551.70
5.	Total award for trustee's damage included in said judgment		$51,401.70
6.	Costs in judgment		$ 1,946.95
7.	Total of judgment		$53,348.65
8.	Interest on above item 5 from Dec. 12, 1950 to payment date		$ 1,798.61
9.	Interest on above item 6 from		

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Dec. 12, 1950 to payment date	$ 69.44
10. Amount respondent paid trustee five days after decision in 302 N. Y. 932	$55,216.70

(For items 1-3 see Apx. pp. 27, 29, 24; items 4-7 p. 30 and item 10 p. 66).

ARGUMENT

I.

As demonstrated therein, Second Circuit's decision rests in principles well established by decisions of this court, and in unequivocal statutory provisions.

In reality, the subordination produced the same effect as if an assignment of respondent's claims to other claim-holders had been directed. So, it constituted an intended *fine* or *penalty* against respondent in the amount of its claims, and a corresponding windfall to other claim-holders.

Apparently such punishment was grounded solely in the fact that the questions of whether (a) the foreclosure sale to respondent was preferential and (b) if it was, the amount lawfully recoverable on account thereof, were litigated and determined in the state court action instituted by trustee.

As the decision indicates, the invalidity of such a penalty was first established in *Koppell* v. *Tiffin Savings Bank*, 197 U. S. 356, decided April 3, 1905.

II.

Second Circuit's unreported decision of March 31, 1955 in Gannett Co. Inc. v. Larry not in conflict with its decision in this proceeding.

This is mentioned because of allegations concerning Gannett decision on pages 38-39 of petition.

As will be seen by comparison of the decisions, Gannett involved circumstances and principles entirely different from those in the instant proceeding.

As appears on last page of Gannett decision, the corporate creditor, Gannett, acquired the corporate bankrupt, Berwin, when the latter was prosperous and solvent, and then produced the insolvency and bankruptcy of Berwin through losses of distinct benefit to Gannett, or at least so intended. There was no attempt by the bankruptcy trustee to recover such losses through litigation or otherwise and no restoration of the losses by anyone.

In complete contrast, here the trustee's full damage from the foreclosure-transfer, as fixed in his state court action, was fully paid by respondent, to mention only one of the many fundamental differences between the two decisions.

III.

Fallacies of petitioners' contentions as to questions presented.

One of petitioners' alleged questions is whether a bankruptcy trustee is empowered to sue for and recover the damage sustained from a preferential-transfer by particular claimholders. (petition, pp. 3, 22-25).

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The complaint in the state court action asked for that type of relief, "and for such other and further relief as may be just and equitable in the premises." (petition, p. 25).

The final decision and judgment in said action awarded the "other and further relief" so requested, namely, the trustee's damage, as fixed therein, by reason of such transfer. (277 App. Div. 1090, 1091; aff. 302 N. Y. 932).

Unquestionably, of course, that adjudication is not now subject to challenge by any party or review by any court. It was not under review by the Second Circuit since the only appeal thereto was from the subordinating part of an order of the Bankruptcy Court.

However, pains were taken in the final state court's decision and judgment to fix and specify therein every element needed for computation and accomplishment of the result that would have obtained if the award therein had been confined to the amount of damages sustained by those holding only $201,210 of claims on the basis of the $54,850 valuation by the state court of the assets transferred on the foreclosure-sale. If the Bankruptcy Court should direct such a result, its order, of course, will be subject to a review in the usual manner.

CONCLUSION

It is submitted the review applied for is insufficiently supported since the Second Circuit's decision seems to conform to prior decisions of this Court and applicable statutes. Besides, it appears evident the principles of the decision can have no general application because of the

explicit limitation thereof to very extraordinary circumstances.

Respectfully submitted,

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